LUCAS FETTES

Taking benefits from your pension

A guide to your options

Introduction

This guide outlines the different options available when you want to access your pension benefits. You have the option to access part, or all, of your pension benefits at any time from age 55 (or your State Pension Age, less 10 years, if this is later, subject to future legislation). This is irrespective of whether you have actually stopped working.

New pension rules introduced in April 2015 changed the way in which pension benefits can be taken. These changes give you a number of options as to how you take benefits and it is really important that the implications of these options are fully understood and accepted before you make any decisions.

The options for most people from age 55 include taking up to 25% of their pension fund as a tax free lump sum and with the residual fund, elect to draw a taxable income via either one of or a combination of the following options:

- annuity purchase;
- flexi-access drawdown;
- uncrystallised funds pension lump sum;
- phased retirement; and
- a combination of the above.

Since April 2015, upon reaching 55 years of age you are able to withdraw any amount from your accrued defined contribution pension arrangements.

Apart from the tax free cash element of the pension fund (usually 25%), funds withdrawn will be added to your taxable income in the year it is received and taxed accordingly depending on which income tax bands the income falls within.

This tax rate could be 20%, 40% or 45% or a combination of these rates depending on the amount withdrawn, together with your other taxable income received in the tax year of making the income withdrawal.

The Government will not prescribe a particular product which you will need to purchase or invest in to access your pension savings. It will be up to you to decide how you want to access your pension benefits. Options include a one-off lump sum, a series of lump sums/ regular payments or to secure a guaranteed income.

You can also use a combination of these options.

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The need for advice

Financial advice isn't simply about recommending a product to you, but determining which solution or combination is most suitable for you. We need to understand your financial circumstances, investment preferences and what you want to achieve, including your goals and ambitions for the future. We will work with you to build a financial plan capable of delivering those objectives.

Tax efficient planning will also be an essential part of the advice process to ensure that you meet your capital and income requirements as tax efficiently as possible and make use of all available tax allowances.

When we design a financial plan to enable you to meet your cash and income requirements in retirement, we also take into account the four major risks that people face:

- longevity;
- inflation;
- investment returns and volatility; and
- later life care costs.

> *"One of the biggest risks facing retirees is inflation."*

After payment of the maximum tax free cash, any income you receive from your plan will be taxable and will be added to any other taxable income you receive to arrive at your marginal rate of income tax.

Pension providers are legally obligated to operate PAYE, so they may be obliged to use an emergency tax code and may therefore deduct a higher rate of tax at source from your income payments than you would ordinarily be liable to pay.

Depending on your other taxable income, the application of the emergency code can also mean that too little income tax is deducted at source. Either way, you may need to contact HMRC to rectify any under or over payments of tax.

Longevity

Estimating life expectancy is very difficult. Nonetheless, you need to consider how long you might reasonably live when planning for your retirement and how much capital and/or income you will need. Many people underestimate how long they will live. Making sensible assumptions will be critical to ensuring that you do not withdraw an unsustainable level of income and exhaust the fund, leaving you with inadequate income.

The idea that we are living longer is highlighted by the Office of National Statistics projections; they suggest that the number of people aged 90-94 will increase from 472,000 to 685,000 in the next 10 years, with a 74% chance that at least one life in a joint life partnership will survive beyond age 90.

Currently a 65 year old male buying an annuity is expected to live on average 21 years, to age 86. For a 65 year old female life expectancy is 23 years, to age 88. In reality, however, 50% of both males and females will live longer than their respective average life expectancies. An annuity is currently the cornerstone of many people's retirement income, and the only product that guarantees to provide a defined income for life, however long that may be.

> *"50% of both males and females will live longer than their respective average life expectancies."*

When deciding whether to purchase an annuity or draw income directly from your pension fund, you will need to consider very carefully whether you can accept the risk that you live longer than you expect (or have planned for) and your money runs out.

Inflation

One of the biggest risks facing retirees is inflation, which even at very low levels (compared to levels experienced, even in the recent past) can have a devastating effect on living standards over time.

Over 20 years, the impact of rising prices on a fixed income (such as a level annuity) is as follows:

- 2.0% inflation reduces real incomes by one-third;
- 3.5% inflation reduces real income by one-half; and
- 5.0% inflation reduces real income by two-thirds.

The effect of compounding means that the problem gets worse the longer people live. A person who took out an annuity paying £10,000 at age 60 and who is now 85 would have found their inflation-adjusted purchasing power had fallen as follows:

Average Inflation	Inflation Adjusted Purchasing Power
2.00%	£6,000
3.50%	£4,100
5.00%	£2,800

In addition, pensioner inflation can be higher than the usual Consumer Prices Index (CPI) measure as they typically spend proportionately much more of their income on items such as food, council tax, fuel and utility bills.

Investment returns and volatility

If you do not buy an annuity, but instead draw income directly from your fund under pension flexibility rules, you will be exposed to ongoing investment risk and value fluctuations. In order to deliver long term returns that protect against the effects of inflation, your pension fund will need to be invested across a diversified range of assets and therefore remain exposed to a degree of investment risk.

This on-going investment risk can result in fluctuations of the underlying asset values. It is important that you understand how volatility, combined with making regular income withdrawals, can affect the value of your fund when deciding where and how to take income.

Making income withdrawals from your fund when the value of the assets are depressed can have a significant impact on the ability of the fund to recover value over the longer term.

Later Life Care Costs

When deciding how to fund your retirement the potential of increased income needs in much later life to fund care costs must be considered carefully. Whilst the State will make some provision for meeting care costs, the danger of running out of money whilst in later life could mean real financial hardship if long term care becomes a reality.

The state pension

The State Pension is intended to ensure that everyone has a basic amount of income to support them in their old age. Since 5th April 2016 – the State Pension has been a single tier or flat rate system providing a maximum pension in the region of £179 per week.

The amount you will receive is based on your National Insurance (NI) record. To qualify for the new State Pension you need at least 10 qualifying years of NI contributions and at least 35 years to get the full State Pension - a proportionate amount will be paid for qualifying years between these levels.

Deferring your State Pension

You can put off claiming your state pension when you reach state pension age if you wish to. This will allow you to build up additional benefits which you can take in the form of extra state pension.

Voluntary National Insurance (NI) contributions

You must be eligible to pay voluntary NI for the time that the contributions cover. You can usually only pay for gaps in your NI record from the past 6 years, depending on your age. Therefore, if relevant, class 2 or 3 NI contributions can be made in order to increase state pension entitlement.

Options for taking your pension benefits

There are a range of options available to you when accessing your pension benefits.

Annuity purchase

Many people have historically purchased a lifetime annuity with their pension funds. This remains a popular option for those who require certainty over their pension income or do not feel comfortable taking any investment risk with their pension fund into retirement.

Purchasing a conventional annuity will ensure that you receive a guaranteed income for life, including provision for your dependent(s) where this option is selected.

There are a number of options when considering which type of annuity to take, whether lifetime or fixed term, as follows:

- Lifetime annuity - you could take benefits through your current provider, this typically involves taking a tax free cash sum of 25% of the fund and purchasing a conventional annuity with the balance of the fund based on the annuity rates they are offering. You need to be aware that your existing provider may not offer you the best annuity rates.
- Open market option - you could transfer the whole value of your pension fund to another provider who offers the best rate for the type of lifetime annuity you want.
- Enhanced/impaired annuity – higher annuity rates are available from certain providers based on health and lifestyle. You may be able to access this option from your existing provider or you may have to take an open market option.
- With profits or unit-linked annuity - you can use the whole of your pension fund after any tax free cash has been paid to purchase a lifetime annuity on a 'with-profits' or unit linked basis with your existing or another provider. These annuities provide a level of income linked to ongoing investment performance but also expose you to ongoing risk.
- Third way or variable annuity - you may transfer your pension fund to a provider offering a lifetime annuity on a flexible basis (often called variable or third way annuities). These types of annuity look to combine the certainty of a lifetime annuity with investment as seen with Flexi-access drawdown (see below).
- Fixed term annuity – you may transfer your pension fund to a provider offering a fixed term annuity. You will select the required term at outset and the required income amount. Some providers will offer a guaranteed maturity value, which you can choose to take as a final income payment, subject to tax and whilst in payment a fixed (level) or increasing regular income. There are also various death benefit options.

Dependents benefits

You may wish to consider dependents benefit options including; choosing a joint life annuity, and/or guaranteed period and/or value protection.

Inflation protection

You may also wish to factor in future inflation and the impact this will have on the purchasing power of your annuity income in the future. You can therefore choose to protect your annuity income by choosing an income which increases each year.

Both of these options are more expensive and will reduce your starting income but over time could pay out more overall.

Flexi-access drawdown

This option was introduced in April 2015 to give you total flexibility as to how and when you access your pension benefits. You can transfer the whole value of your pension fund into a Flexi-access Drawdown plan which allows you to vary future capital and income levels to fit in with your needs and overall financial plan.

The remaining fund will continue to be invested and under your control. There are no minimum or maximum income limits dictating how much you can take out at any given time; and if you wish you can just access the tax free cash initially and defer taking any income until a later date. This will then be subject to income tax at your highest rate.

Flexi-access Drawdown is considered high risk when compared to a lifetime annuity as the income is not secure and could run out if not managed correctly.

If the fund performs well relative to the level of income withdrawn, it may be possible to increase the level of income you withdraw over the years. Adopting a flexible income approach could therefore provide a degree of protection against inflation if the level of income is managed sensibly.

"You could face a significant tax bill if you cash in your entire pension at once."

However, if performance is poor and/or the amount of income taken from the fund cannot be supported by the net investment returns, both the fund value and future income will be reduced, potentially to zero, in extreme circumstances.

Once you are in Flexi-access Drawdown, you can still purchase an annuity at any time.

Uncrystallised funds pension lump sum

This is a further option also available since April 2015 under which you can withdraw a single (or series of) lump sums from your existing pension without the need to move the funds into a drawdown plan first.
The nature of the payments you received under this feature is that 25% of the fund (or 25% of each payment if less than the total fund is withdrawn) will be tax free; and the balance taxed at your marginal rate(s) of income tax.

Not all pension arrangements will offer the flexibility to withdraw benefits as a series of lump sums; therefore in some circumstances it will be necessary to transfer the pension fund to a more flexible arrangement before this method of drawing benefits can be accessed.

Phased or partial retirement

You can convert your retirement fund into income in stages over a number of years (often referred to as staggered vesting or phased retirement), using either Annuity or Drawdown. This may be available with your current pension arrangement or you may need to transfer your existing pension funding into a new arrangement.

Each time you need to access some money you can take up to 25% tax free cash plus a taxable income. It can be tax efficient if you control your tax free cash and income to take advantage of your personal tax allowances.

You can also use your pension fund to utilise a combination of these options.

What happens on death?

For those who are under the age of 75 at the time of death, it will be possible to leave the whole of the remaining pension fund to any beneficiary of their choice, tax free. This can then be taken in the form of a lump sum or series of income payments.

For those who are 75 and over at the time of death, irrespective of whether the remaining fund is taken as a lump sum or a series of income payments, death benefits will be subject to income tax at the beneficiary's marginal rate.

Inheritance tax planning

In light of the new pension rules, as death benefits from a pension will now be available to any named beneficiary, not just your spouse or financial dependent, this provides much greater flexibility in how your pension death benefits can be used.

Retaining pension wealth within a pension fund and passing it down to future generations could be an extremely tax efficient estate planning solution.

In most cases, your pension death benefits will not be subject to inheritance tax and your beneficiaries may be able to benefit from tax-free investment returns, plus potentially tax free withdrawals.

The previous wisdom of stripping out funds and gifting the surplus income to minimize the impact of the 55% tax charge on death has given way to retaining funds within the pension as a more tax efficient solution.

Pension flexibilities and DWP benefits

A further consideration when deciding how and how much pension benefits should be drawn is the potential impact on income-related DWP benefits such as:

- employment and support allowance;
- housing benefit;
- income support;
- jobseekers allowance;
- pension credit; and
- universal credit.

How your pension is treated will depend on whether you or your partner have reached the qualifying age for pension credit. You can find out your qualifying age for pension credit by using the GOV.UK State Pension Calculator at www.gov.uk/calculate-state-pension.

The way in which you use flexible pension options could affect your future entitlement to benefits. If you or your partner take money out of your pension before you have reached the qualifying age for pension credit, it will be treated as either income or capital, depending on how frequently you withdraw it. If you do not take any money out of your pension, it will not be taken into account when your benefit entitlement is calculated.

Once you reach the qualifying age for pension credit you are expected to use your pension to support yourself.

If you choose not to buy an annuity after reaching the qualifying age for pension credit, an amount of notional income will be taken into account when your benefits are worked out. Notional income is essentially an amount equivalent to the income you would have received if you had bought an annuity.

Deprivation of Assets

If you spend, transfer or give away any money that you take from your pension , DWP will consider whether you have deliberately deprived yourself of that money in order to secure or increase your entitlement to benefits.

If it is decided that you have deliberately deprived yourself, you will be treated as still having that money and it will be taken into account as income or capital when your benefit entitlement is worked out.

If you are in receipt of any of the above benefits, we will consider the likely impact your chosen income strategy will have on those benefits in preparing our advice.

Pension funding limits whilst accessing pension benefits

The pensions money purchase annual allowance (MPAA), is £4,000 per year. The MPAA was introduced to prevent savers abusing pension rules by taking money out of their pension and then reinvesting it in the same year to benefit from extra tax relief.

The general rule is that you can contribute the lower of your annual earned income or £40,000 per year into a pension arrangement. However, this allowance is reduced if you withdraw any taxable income from a defined contribution pension pot under pension flexibility rules (being in capped drawdown, which was only available prior to 6 April 2015, or purchasing a traditional annuity, does not trigger the MPAA).

It is this limit that is referred to as the money purchase annual allowance (MPAA).

The application of the MPAA rule can hold potential tax consequences where you have accessed benefits flexibly from a defined contribution pension pot and have also been automatically enrolled into a workplace pension scheme with contributions exceeding £4,000 per annum.

Individual consideration may therefore need to be given to retaining scheme membership and suffering the annual allowance charge where contributions exceed £4,000 per year, or opting-out of the auto-enrolment scheme.

In conclusion

The new rules give you freedom and choice as to when and how you access your pension benefits. However, you could face a significant tax bill if you cash in your entire pension at once, rather than in stages making use of available tax rates and allowances.

In addition, a pension is to provide funds for your retirement. State pension benefits are unlikely to provide you with a sufficient income in order to enjoy a comfortable retirement so it would be unwise to take all your pension savings early and then rely solely on the state pension in the future.

Contact us

If you would like further information on any of the above services or how we can help you, please do not hesitate to contact your Lucas Fettes Financial Planning adviser, call us on 01603 706 820 or email info@lffp.co.uk

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Important information

The way tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to future change. Pension eligibility depends on individual circumstances.

This document is solely for information purposes and nothing in it is intended to constitute advice or a recommendation. You should not make any investment decisions based on its content.

The value of investments can fall as well as rise and you may not get back the amount you originally invested.

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